

Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Special Counsel to the National Taxpayer Advocate

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subject: Pigford v. Schafer: Debt Relief Issues

Issues

This memorandum addresses certain federal income tax issues raised by the settlement of Pigford v. Schafer, a class action lawsuit brought on behalf of African-American farmers against the United States Department of Agriculture (USDA). The claimants alleged discriminatory treatment, and the settlement provides, in part, for the forgiveness of certain USDA loans made to the claimants. This memorandum addresses the following issues:

- (1) The years in which claimants realize discharge of indebtedness income as a result of debt forgiveness;
- (2) The years for which the USDA is required to issue information returns to report the claimants' discharge of indebtedness income;
- (3) Whether there could be reporting of "net" amounts on Forms 1099-C in cases where a decision resulted in a "switch" of the specific loan or loans forgiven, so that one loan is reinstated and another forgiven; and
- (4) What obligation does USDA have to issue corrected forms for past years?¹

Conclusions

¹ This memorandum does not address whether an individual claimant can exclude any realized discharge of indebtedness income from gross income under section 108 of the Internal Revenue Code. That provision permits the exclusion of discharge of indebtedness income under various circumstances, including insolvency and when the forgiven debt is "qualified farm indebtedness," as defined by the statute. Nor do we address a claimant's duty to report as income amounts paid by USDA to compensate the claimant for tax liability arising from a cash award or debt forgiveness.

(1) Pigford claimants may realize discharge of indebtedness income in a number of tax years, as events occur that affect the amount of debt forgiven. In some cases, claimants may have deductible losses if debt previously considered forgiven and reported as income is reinstated.

(2) The years for which the USDA is required to issue information returns to report the claimants' discharge of indebtedness income depends on the year in which the last event necessary to effectuate a discharge occurred. In this case, the events necessary to effectuate discharges of indebtedness occurred in a number of years, thus requiring information returns for a number of years.

(3) There should not be reporting of "net" amounts on Forms 1099-C. Where a decision resulted in a "switch" of the specific loan or loans forgiven, so that one loan is reinstated and another forgiven, the full amount of the loan that is forgiven must be reported on Form 1099-C in the year in which the last event necessary to effectuate the discharge occurred. In cases where a loan is reinstated, there is no further reporting required for discharged debt that was reported on a Form 1099-C for a prior year.

(4) If Forms 1099-C reporting the discharges of indebtedness were filed incorrectly by the USDA, corrections should be submitted for returns filed within the last three calendar years.

Facts

A Consent Decree dated April 14, 1999, sets forth the terms of the settlement. It establishes two "tracks" for resolving claims. Section 9 describes "Track A." A claimant proceeding under Track A must demonstrate to an "adjudicator" that:

- (A) The claimant owned or leased, or attempted to own or lease, farm land;
- (B) The claimant applied for a specific credit transaction at a USDA county office during the period [1981-1996];
- (C) The loan was denied, provided late, approved for a lesser amount than requested, encumbered by restrictive conditions, or USDA failed to provide appropriate loan service, and such treatment was less favorable than that accorded specifically identified, similarly situated white farmers; and
- (D) USDA's treatment of the loan application led to economic damage.

If the adjudicator determines that a claimant has made the required showing, the Consent Decree provides for various forms of relief. The debt forgiveness component is described as follows: "USDA shall discharge all of the class member's outstanding debt to USDA that was incurred under, or affected by, the program(s) that was/were the

subject of the ECOA [Equal Credit Opportunity Act] claim(s) resolved in the class member's favor by the adjudicator.”²

A court-appointed “Monitor” is charged with monitoring implementation of the Consent Decree and making reports to the Court. The Monitor also has the authority to “[d]irect the facilitator, adjudicator, or arbitrator to reexamine a claim where the Monitor determines that a clear and manifest error has occurred in the screening, adjudication, or arbitration of the claim and has resulted or is likely to result in a fundamental miscarriage of justice.” Sec. 12(b)(iii) of the Consent Decree. Pursuant to an April 4, 2000, “Order of Reference,” a 120-day period was instituted for the filing of petitions seeking Monitor review of decisions. The parties were given until July 2000 to petition for the review of decisions already issued.

Disputes arose among the parties regarding interpretation of the Consent Decree provision for debt relief for successful claimants. A February 7, 2001, Stipulation and Order resolved one such dispute. The parties agreed that claimants were entitled to forgiveness of not only that debt that was the subject of a discrimination claim decided in the claimant's favor, but also any subsequent debt incurred under the same loan “program”³ administered by the USDA. The agreement that such subsequent debt also should be forgiven has been referred to as the “forward sweep.”

In 2008, the parties resolved another issue concerning the scope of debt relief. They agreed that the subsequent debt forgiven pursuant to the forward sweep should be considered forgiven as of the date the adjudicator or arbitrator's decision in favor of the claimant became final (rather than on the date of the agreement for a forward sweep). Thus, if a decision in favor of a claimant became final in February 2000, the amount of the subsequent debt forgiven should be its balance as of February 2000. This agreement necessitated the refund of certain payments made on the subsequent debt, as well as the refund of certain amounts collected through offset, e.g., by withholding government benefits. See Monitor Update No. 10.

Finally, the Monitor's office is currently engaged in a review of most or all decisions involving credit discrimination claims to ensure that the proper amount of debt relief has been awarded.

² Other relief awarded to qualifying Track A claimants includes a cash award of \$50,000 and tax deposits equal to 25% of the cash award and principal amount of the forgiven debt, respectively.

“Track B” is described in Section 10 of the Consent Decree. Decisions are made by an “arbitrator,” rather than an adjudicator, and only after an evidentiary hearing. A Track B claimant is required to demonstrate the required discrimination by a preponderance of the evidence. The benefit to a claimant of pursuing this more rigorous process is the potential recovery of actual monetary damages under the ECOA, rather than the prescribed \$50,000 award provided to successful Track A claimants.

³ The USDA made loans under various programs, e.g., Operating Loans, Farm Ownership Loans, and Emergency Loans.

Law– Issue (1)

Section 61(a)(12) of the Internal Revenue Code provides that gross income includes income from the discharge of indebtedness.

In United States v. Kirby Lumber Co., 284 U.S. 1 (1931), a corporation repurchased its bonds for an amount less than their par value. The Court held that this resulted in an accession to wealth because, to the extent of the difference, the corporation's assets had been released from a liability.

Regarding when a taxpayer realizes discharge of indebtedness income, the Tax Court stated in Cozzi v. Commissioner, 88 T.C. 435, 445 (1987):

The moment it becomes clear that a debt will never have to be paid, such debt must be viewed as having been discharged. The test for determining such moment requires a practical assessment of the facts and circumstances relating to the likelihood of payment. Brountas v. Commissioner, 74 T.C. 1062, 1074 (1980), supplemental opinion to 73 T.C. 491 (1979), vacated and remanded on other grounds 692 F.2d 152 (1st Cir. 1982), affd. in part and revd. in part on other grounds sub nom. CRC Corp. v. Commissioner, 693 F.2d 281 (3d Cir. 1982); see Bickerstaff v. Commissioner, 128 F.2d 366, 367 (5th Cir. 1942); Kent Homes Inc. v. Commissioner, 55 T.C. 820, 828-831 (1971), revd. on other grounds 455 F.2d 316 (10th Cir. 1972); Cotton v. Commissioner, 25 B.T.A. 1158 (1932). Any "identifiable event" which fixes the loss with certainty may be taken into consideration. United States v. S.S. White Dental Mfg. Co., 274 U.S. 398 (1927).

In Exchange Security Bank v. United States, 492 F.2d 1096 (5th Cir. 1974), a settlement agreement between the taxpayer and his creditor received judicial approval but was the subject of an appeal. The court held that the taxpayer realized discharge of indebtedness income in the year the settlement received judicial approval, notwithstanding the appeal, and that any reversal of the debt forgiveness would entitle the taxpayer to a loss deduction:

The right to receive cancellation of the debt accrued to appellants in March, 1959, and it was reaffirmed by the judicial order in August, 1959, Texas Trailercoach, Inc. v. C.I.R., 5 Cir., 1958, 251 F.2d 395. At that point it was determined with certainty that the debt could never be enforced, Koehring v. United States, 421 F.2d 715, 190 Ct. Cl. 898 (1970); Helvering v. Jane Holding Corp., 8 Cir., 1940, 109 F.2d 933, cert. denied, 310 U.S. 653, 60 S. Ct. 1102, 84 L. Ed. 1418 (1940). The faint possibility of required revival as a consequence of a future appeal to this Court did not change the actual realization of the gain, James v. United States, 366 U.S. 213, 81 S. Ct. 1052, 6 L. Ed. 2d 246 (1961); North American Oil Consolidated

v. Burnet, supra; Buder v. United States, 8 Cir., 1966, 354 F.2d 941. Indeed, it is clear that if the debt had been revived, appellants would still have been required to report the realized income and subsequently claim the loss, United States v. Lewis, 340 U.S. 590, 71 S. Ct. 522, 95 L. Ed. 560 (1951).

Id. at 1099-1100.

Analysis – Issue (1)

Applying the foregoing principles to the instant situation, we conclude that Pigford claimants may realize discharge of indebtedness income in a number of tax years, as events occur that result in the forgiveness of debt. A discussion of those events follows.

Final Decision of Adjudicator/Arbitrator

Claimants realize discharge of indebtedness income when the adjudicator's or arbitrator's decision awarding debt relief becomes final, so long as there is some basis for identifying the loan(s) forgiven. If there has been no petition for Monitor review, a decision generally will be final after expiration of the 120-day period for filing a petition (or in July 2000 in the case of the earliest decisions). If a petition has been filed regarding a decision favorable to a claimant, the decision becomes final either when the petition has been denied by the Monitor or when the original decision to forgive debt has been upheld upon reexamination by the adjudicator or arbitrator.⁴ If a petition is filed regarding a decision denying relief to a claimant and the decision is reversed, discharge of indebtedness income is realized when the revised decision is rendered.⁵

While in Exchange Security Bank v. United States, 492 F.2d 1096, the court found there to be discharge of indebtedness income prior to final judicial affirmance of a court-approved settlement, the case is distinguishable in that there the parties had mutually agreed that debt would be forgiven. Here, pending Monitor review, there has been no agreement regarding the debt relief in an individual case.

On the other hand, any administrative delay in "implementing" a decision does not affect the year in which a claimant realizes discharge of indebtedness income. Once a decision becomes final, debt has legally been forgiven. The USDA would be under an obligation to return any amounts collected improperly due to administrative error, and,

⁴ Exceptions to this general rule would include instances in which the USDA demonstrates, prior to expiration of the 120-day period, that it will not contest a claimant-favorable decision.

⁵ Note that the date a decision becomes final for purposes of determining when a claimant realizes discharge of indebtedness income can differ from the date used for purposes of determining the amount of debt forgiven and whether payments subsequent to such date are to be refunded. The latter issue is addressed in Monitor Update No. 10.

therefore, irrespective of the delay in implementing the decision, a claimant has an accession to wealth within the meaning of United States v. Kirby Lumber Co., 284 U.S. 1 (1931).⁶

Additional Debt Relief Under “Forward Sweep”

Claimants realized additional discharge of indebtedness income as the result of the February 7, 2001, Stipulation and Order, which provides for the forgiveness of subsequent loans made under the same program as the loan that is the subject of a discrimination finding. Prior to the order, there was neither an agreement nor an order that such debt be forgiven. Thus, it was reasonable to assume that this debt would be enforced. The additional debt relief was realized in tax year 2001.

Additional Debt Relief Under Agreement to Make “Forward Sweep” Retroactive

Claimants realized additional discharge of indebtedness income in 2008 as a result of the 2008 agreement to make the forward sweep retroactive to the date the adjudicator’s or arbitrator’s decision became final so that a refund of payments or offsets is required. Prior to this agreement, it was reasonable to assume that the additional balance of the subsequent debt on this earlier date would be enforced. The refund of payments and offsets pursuant to this agreement should be distinguished from the refund of payments and offsets necessitated by delays in implementing debt relief, *i.e.*, those necessitated by administrative error. As explained earlier, administrative delays in implementing debt relief are not relevant to the timing of discharge of indebtedness income.

Miscellaneous Realization Events

The modification of a decision (either as the result of a petition for Monitor review, a *sua sponte* review, or the current “global” review) can result in additional discharge of indebtedness income if additional debt is forgiven. Conversely, modification of a decision may result in a deductible loss if there is a reversal of previously awarded debt relief that has been included in gross income. See Exchange Security Bank v. United States, 492 F.2d at 1100.

Similarly, where review of a decision results in a “switch” of the specific loan or loans forgiven, so that one loan is reinstated and another forgiven to reflect the true intent of the arbitrator or adjudicator, a claimant may deduct as a loss the amount of debt previously included in income under the discharge of indebtedness doctrine and should report as income the amount of the newly-forgiven debt. This assumes that no amount of the debt initially discharged qualified for exclusion from gross income in the year it

⁶ In certain cases, the amount of debt forgiven will include, in addition to the balance owed on the date of the decision, an additional amount representing amounts collected by offset but which the USDA will refund to the successful claimant. A USDA Notice FLP-145, dated July 31, 2000, states the agency’s policy that where a claimant prevails on a credit claim, offsets made after January 1, 1999, will be refunded.

was discharged and that no amount of the reinstated debt would qualify for exclusion from gross income.

Law – Issues (2), (3), and (4)

Section 6050P of the Internal Revenue Code requires that an applicable entity report any discharges (in whole or in part) of indebtedness of any person in excess of \$600.

Section 1.6050P-1(a)(1) of the Income Tax Regulations provides that solely for purposes of the reporting requirements of section 6050P, a discharge of indebtedness is deemed to occur, except as otherwise provided in paragraph (b)(3) of this section, if and only if an identifiable event has occurred, whether or not an actual discharge of indebtedness has occurred on or before the date of the identifiable event.

Section 1.6050P-1(b)(2) provides that solely for purposes of section 6050P, with certain exceptions, a discharge of indebtedness occurs if one of the following eight identifiable events takes place:

- (A) A discharge of indebtedness under title 11 of the United States Code (bankruptcy);
- (B) A cancellation or extinguishment of an indebtedness that renders a debt unenforceable in a receivership, foreclosure, or similar proceeding in a federal or State court, as described in section 368(a)(3)(A)(ii) (other than a discharge described in paragraph (b)(2)(i)(A) of this section);
- (C) A cancellation or extinguishment of an indebtedness upon the expiration of the statute of limitations for collection of an indebtedness, subject to the limitations described in paragraph (b)(2)(ii) of this section, or upon the expiration of a statutory period for filing a claim or commencing a deficiency judgment proceeding;
- (D) A cancellation or extinguishment of an indebtedness pursuant to an election of foreclosure remedies by a creditor that statutorily extinguishes or bars the creditor's right to pursue collection of the indebtedness;
- (E) A cancellation or extinguishment of an indebtedness that renders a debt unenforceable pursuant to a probate or similar proceeding;
- (F) A discharge of indebtedness pursuant to an agreement between an applicable entity and a debtor to discharge indebtedness at less than full consideration;
- (G) A discharge of indebtedness pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge debt; or

(H) The expiration of the non-payment testing period, as described in paragraph (b)(2)(iv) of this section. See § 1.6050P-1T.

Treas. Reg. § 1.6050P-1(e)(9) provides that if discharged indebtedness is reported under this section, no additional reporting is required for the amount reported, notwithstanding that a subsequent identifiable event occurs. Further, no additional reporting or Form 1099-C correction is required if a creditor receives a payment of all or a portion of a discharged indebtedness reported under this section for a prior calendar year.

Section 8.09 of Rev. Prov. 2008-30, 2008-23 I.R.B. 1056, provides that, in general, filers should submit corrections for Form 1099-Cs filed within the last three calendar years.

Analysis – Issues (2), (3) and (4)

(2) Years for which the USDA is required to issue information returns to report the claimants' discharge of indebtedness income.

Final Decision of Adjudicator/Arbitrator

The identifiable event that applies in this case is described in 1.6050P-1(b)(2)(F), an agreement between an applicable entity and the debtor to discharge the indebtedness at less than full consideration. This identifiable event will not occur until the last event necessary to effectuate the discharge has occurred. See T.D. 8654, 61 FR 262 (January 4, 1996). In 1999, the USDA (an applicable financial entity) and the claimants (the debtors) agreed to the settlement of Pigford v. Schafer, which has resulted in the forgiveness of certain USDA loans made to the claimants. Consequently, the USDA must file information returns under section 6050P for any amounts of discharged indebtedness for which the last event to effectuate the discharge has occurred. In general, the last event to effectuate the discharge occurs upon the adjudicator's or arbitrator's final decision awarding debt relief.⁷

However, because section 6050P requires reporting of discharges "in whole or in part," there can be a series of amounts that require reporting on Forms 1099-C. The additional amounts of discharged indebtedness occurring subsequent to a final adjudicator or arbitrator decision are discussed below.

Additional Debt Relief Under "Forward Sweep"

⁷ As discussed earlier, a final decision awarding relief occurs in various circumstances. Generally, a claimant-favorable initial decision will become final when the period for petitioning the Monitor expires, unless a petition has been filed, in which case the decision will become final when the petition is denied or the initial decision is reaffirmed upon reexamination. In the case of initial decisions adverse to a claimant that are appealed, discharge of indebtedness will occur when, after reexamination, a decision favorable to the claimant is rendered.

Under the forward sweep, claimants realized additional discharge of indebtedness income as a result of the February 7, 2001, Stipulation and Order. Prior to the order, there was neither agreement nor an order that such debt be forgiven. Although the debt relief to the claimants originated with the settlement agreement between the USDA and the claimants, in the case of the forward sweep, the Stipulation and Order dated February 7, 2001, was the last event necessary to fix the claimant's right to receive this additional amount of debt relief. Accordingly, the identifiable event triggering the information reporting requirement for debt relief under the forward sweep occurred on February 7, 2001. Thus, calendar year 2001 is the year for which Forms 1099-C are required to report the debt relief under the forward sweep.

Additional Debt Relief Under Agreement to Make "Forward Sweep" Retroactive

The claimants realized additional discharge of indebtedness income as a result of the 2008 agreement to make the forward sweep retroactive to the date the adjudicator's or arbitrator's decision became final so that a refund of payments or offsets was required. Prior to this agreement, it was not clear that the additional balance of the subsequent debt on this earlier date was forgiven. Thus, in the case of additional debt relief under the agreement to make the forward sweep retroactive, the last event to effectuate the debt relief under such agreement did not occur until 2008. Accordingly, the identifiable event triggering the information reporting requirement under section 6050P for such additional debt relief occurred in 2008, and that is the year for which the USDA is required to issue Form 1099-C.

Miscellaneous Realization Events

There are also miscellaneous realization events that result in discharge of indebtedness income. Modifications, either as a result of a petition for Monitor review, a *sua sponte* review, or the current "global" review, can result in either additional discharge of indebtedness or a reversal of previously awarded debt relief. Similarly, a review of a decision can result in a "switch" of the specific loan or loans forgiven, so that one loan is reinstated and another forgiven to reflect the true intent of the arbitrator or adjudicator. If a switch or modification results in a reversal of previous debt relief, a claimant may deduct a loss for the amount of debt previously included in income.

When a loan is reinstated as a result of a modification or switch, we conclude that no additional reporting is required. Section 6050P only requires reporting of discharges of indebtedness, not the incurrence or reinstatement of indebtedness. In addition, reporting under section 6050P is required only upon the occurrence of an identifiable event. Reinstatement of a loan is not one of the eight identifiable events. Further, section 1.6050P-1(e)(9) provides that if discharged indebtedness is reported under this section, no further reporting is required for the amount reported, notwithstanding that a subsequent identifiable event occurs. Likewise, there is no additional reporting by the USDA under section 6050P, or Form 1099-C correction required, if a creditor receives payment of all or a portion of the amount discharged. Thus, if the USDA reports debt

canceled for a claimant on Form 1099-C and subsequently that debt is reinstated, no additional reporting is required for that loan amount. The claimant nonetheless may be entitled to a loss in such situations if they have previously included the discharge of debt in income.

However, in the case of a modification or switch that results in additional discharge of indebtedness income, or if additional debt is forgiven where another loan is discharged, Form 1099-C is required for the year in which the identifiable event occurred for that additional or new discharge, i.e. the year in which the last event to effectuate the modification or switch occurs. The amount reported on the Form 1099-C in such cases is the total amount of debt canceled as a result of the modification or switch for each claimant.

(3) Whether there could be reporting of a “net” amount on Form 1099-C.

We conclude that there should not be a “net” reporting on Form 1099. As discussed above under “Miscellaneous Realization Events,” in the case of modifications or switches that result in both additional discharge of debt and a reinstatement of a loan, each event should be treated separately. The additional debt discharged must be reported on a Form 1099-C in the year in which the last event to effectuate the modification or switch occurs. There is no further reporting required where cancelled indebtedness that has previously been reported on Form 1099-C is reinstated.

(4) What obligation does USDA have to issue corrected forms for past years?

The general rule is that corrections should be submitted for Forms 1099-C filed within the last three calendar years. See Rev. Proc. 2008-30. If Forms 1099-C reporting the discharges of indebtedness were filed incorrectly by the USDA, corrections should be submitted for returns filed within the last three calendar years.

Please call (202) 622-4960 if you have any further questions.